LIBRARY
SUPREME COURT, U.S.

Office - Supreme Court, U. S.
FILED
JAN 13 1956
HAROLD B. WILLEY, Clerk

No. 373

In the Supreme Court of the United States

OCTOBER TERM, 1955

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

SIMON E. SOBELOFF,
Solicitor General,
H. BRIAN HOLLAND,
Assistant Attorney General,
PHILIP ELMAN,
Assistant to the Solicitor General,
MILBERT P. SARNEY,
JOSEPH F. GOETTEM,
Attorneys,
Department of Justice,
Washington 25, D. C.

INDEX

	Page
Opinions below	1
Jurisdiction	1
Question presented	2
Statute and Regulations involved	2
Statement	5
Summary of argument	17
Argument:	
The Treasury Regulations, under which an employee realizes taxable income in acquiring stock in his employer corporation for less than fair market value, represent a reasonable and valid interpretation of the statute. The "proprietary interest" test applied by the lower courts is illogical and erroneous	19
A. In general: The nature of the issue	19
B. The statute and the Regulations	25
C. Under the statute and Regulations the taxpayer clearly received income in the nature of compensation	28
D. The "proprietary interest" test, applied by the courts below, is erroneous under the statute	34
E. The amount of compensation involved	46
Conclusion	47

CITATIONS

Cases:	
Adams v. *Commissioner*, 39 B.T.A. 387	34
Bass v. *Hawley*, 62 F. 2d 721	39
Bogardus v. *Commissioner*, 302 U.S. 34	28
Boske v. *Comingore*, 177 U.S. 459	45
Bowen v. *Commissioner*, decided July 22, 1954	34
Bradner v. *Commissioner*, decided June 4, 1952, affirmed, 209 F. 2d 956	34
Brewster v. *Gage*, 280 U.S. 327	45
Commissioner v. *Bonwit*, 87 F. 2d 764, certiorari denied, 302 U.S. 694	42
Commissioner v. *Glenshaw Glass Co.*, 348 U.S. 426	25
Commissioner v. *Jacobson*, 336 U.S. 28	25
Commissioner v. *Smith*, 324 U.S. 177, rehearing denied, 324 U.S. 695	21, 26, 29, 46
Commissioner v. *South Texas Co.*, 333 U.S. 496	45
Commissioner v. *Straus*, 208 F. 2d 325	34
Commissioner v. *Wheeler*, 324 U.S. 542	45
Douglas v. *Willcuts*, 296 U.S. 1	25
Eliasberg v. *Standard Oil Co.*, 92 A. 2d 862, affirmed *per curiam*, 97 A. 2d 437	42
Elster v. *American Airlines*, 100 A. 2d 219	42
Fawcus Machine Co. v. *United States*, 282 U.S. 375	45

Cases—Continued

	Page
Geeseman v. *Commissioner*, 38 B.T.A. 258	26
Gottlieb v. *Heyden Chemical Corp.*, 92 A. 2d 594	42
Helvering v. *Bruun*, 309 U.S. 461	25
Helvering v. *Clifford*, 309 U.S. 331	25
Helvering v. *Northwest Steel Mills*, 311 U.S. 46	25
Helvering v. *Wilshire Oil Co.*, 308 U.S. 90	45
Holthusen v. *Edward G. Budd Mfg. Co.*, 53 F. Supp. 488	43
Irwin v. *Gavit*, 268 U.S. 161	25
Kaufman v. *Shoenberg*, 91 A. 2d 786	42
Kerbs v. *California Eastern Airways*, 90 A. 2d 652, reargument denied, 91 A. 2d 62	42
Lykes v. *United States*, 343 U.S. 118	45
Old Colony Tr. Co. v. *Commissioner*, 279 U.S. 716	30
Palmer v. *Commissioner*, 302 U.S. 63	26
Robertson v. *United States*, 343 U.S. 711	25, 30, 40, 44
Rogers v. *Hill*, 289 U.S. 582	42
Rosenberg v. *Commissioner*, 20 T.C. 5	34
Rutkin v. *United States*, 343 U.S. 130	25
Truncale v. *Universal Pictures Co.*, 76 F. Supp. 465	43
Van Dusen v. *Commissioner*, 8 T.C. 388, affirmed, 166 F. 2d 647	39

Statutes:

Income Tax Act of 1913, c. 16, 38 Stat. 114, Sec. II	25
Internal Revenue Code of 1939:	
Sec. 22 (26 U.S.C. 1952 ed., Sec. 22)	2, 20, 25, 36
Sec. 130A (26 U.S.C. 1952 ed., Sec. 130A)	37
Internal Revenue Code of 1954, Sec. 421 (26 U.S.C. 1952 ed., Supp. II, Sec. 421)	37
Stabilization Act of 1942, c. 578, 56 Stat. 765 (50 U.S.C. Appendix, 1946 ed., Secs. 961-971)	33

Miscellaneous:

32 Code of Federal Regulations (1943 Supp.), c. XVIII, Sec. 4001.10	33
Mim. S.S.U. 65, August 15, 1944 (1945 C.C.H., par. 53.105)	33
S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 59-60 (1950-2 Cum. Bull. 483, 526)	37
Surrey & Warren, *Federal Income Taxation* 603 (Second ed., 1953)	44
Treasury Regulations 111:	
Sec. 29.22(a)-1	3, 27, 45
Sec. 29.22(a)-1, as amended by T.D. 5507, 1946-1 Cum Bull. 18	4, 27
Sec. 29.23(a)-16	33

In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 373

COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

PHILIP J. LOBUE

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The findings of fact and opinion of the Tax Court (R. 142-149) are reported at 22 T.C. 440. The opinion of the Court of Appeals (R. 159-164) is reported at 223 F. 2d 367.

JURISDICTION

The judgment of the Court of Appeals was entered on June 9, 1955. (R. 164.) The petition for a writ of certiorari filed on September 2, 1955, was granted on November 14, 1955. (R. 164.) The jurisdiction of this Court rests upon 28 U.S.C., Section 1254.

QUESTION PRESENTED

When an employee is permitted to buy stock in his employer corporation at a price less than fair market value, and where no gift is involved, is the resulting gain to the employee to be excluded from his taxable income simply because the employer intended him to acquire a proprietary interest in its business?

STATUTE AND REGULATIONS INVOLVED

Internal Revenue Code of 1939:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

(b) Exclusions from Gross Income.—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

* * * * *

(3) [As amended by Sec. 111(a) of the Revenue Act of 1942, c. 619, 56 Stat. 798] Gifts, bequests, devises, and inheritances,—The value of property acquired by gift, bequest, devise, or inheritance. * * *

* * * * *

(26 U.S.C. 1952 ed., Sec. 22.)

Treasury Regulations 111, promulgated under the Internal Revenue Code of 1939:

Sec. 29.22(a)-1. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the

subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * *

* * * * *

Sec. 29.22(a)-1 [As amended by T.D. 5507, 1946-1 Cum. Bull. 18]. *What Included in Gross Income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. * * *

* * * * *

If property is transferred by a corporation to a shareholder, for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, such shareholder shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of a distribution of earnings or profits taxable as a dividend. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * *

If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and shall be included in the gross income of the employee. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income.

* * * * *

STATEMENT

From September 1941, to February 28, 1947, the taxpayer was employed as manager of the New York sales division of the Michigan Chemical Corporation. There was no written contract covering the terms and conditions of his employment. The nature and extent of his duties remained the same throughout this period. He received a salary of $6,000 per annum in 1944 and 1945, and of $6,600 per annum in 1946 and 1947. (R. 143.)

Michigan Chemical Corporation was engaged in the business of producing and selling chemical products. The company's chief executive officer, one T. C. Davis, because of his long-standing belief that both the company and its employees profited from employee stock ownership, felt that the corporation should provide some means by which its

employees could acquire a proprietary interest in the business. Mr. Davis discussed his ideas with the directors and officers of the corporation, and, at a stockholder's meeting on March 21, 1944, proposed that key employees be given an option to purchase stock. On that date the stockholders approved a plan of the board of directors whereby 10,000 shares of the corporation's common stock would be made available through options to certain key employees of the corporation over the ensuing three years. At that time the fair market value of the stock was $4.50 a share and the option price was fixed at $5 a share.[1] (R. 143.)

By a letter from Mr. Davis dated June 29, 1944, the taxpayer was informed of the terms and conditions of the employee stock option plan and of its purpose to provide an incentive to key employees and to permit them to participate in the success of the corporation. The taxpayer was congratulated on having been included in the list of those selected as competent to perform outstanding service and thereby participate in the future of the corporation. He was advised that the allotment of stock to key men would be based on results accomplished and that monthly figures during the year would show the results of his efforts. Basic factors which should directly affect his accomplish-

---

[1] The corporation's application to sell 5,000 shares to T. C. Davis and 10,000 shares to key employees designated by the board of directors was approved by the Corporation and Securities Commission of the State of Michigan on June 15, 1945. (R. 23-24.)

ments were enumerated, and it was suggested that he select those areas in which he could make the greatest contribution.[2] (R.17-18.)

---

[2] Following is the full text of the letter of June 29, 1944 (R. 17-18);

June 29, 1944.

Mr. Philip J. LoBue
Palisades Park, N. J.

Dear Phil:

As you know, the stockholders of your company at their meeting in March, 1944, set aside ten thousand shares of the common stock of Michigan Chemical Corporation for allotment to key employees, under a purchase plan at the price of $5.00 per share. The purpose of this is to provide an incentive to key employees and especially to permit such men to participate in the success of the Company. This is a method or plan which has been followed by many of the leading American corporations.

The stock has been set up in the form of options running for a maximum of three years, or such lesser period of time as the Committee may determine. Allotment of the stock will be made by the Committee to the key men of the Company on results accomplished. In other words, you will stand on your own record and participate in the stock purchase plan to the extent of your efforts, cooperation and results.

In order that our plan can begin to function, it has been decided now to tentatively allot ten shares of stock to each one of a selected list of key employees, subject to the following conditions:

1. This tentative allotment will only become definite on January 1st, 1945, and only provided the Company's operations for the year 1944 have been profitable.

2. The stock will be issued by the Company direct to the employee upon payment therefor at the rate of $5.00 per share and as directed by the Committee.

3. The stock cannot be paid for nor received by the employee before June 30th, 1945. Participation in the plan or receipt of stock is entirely contingent upon his being employed by Michigan Chemical at that time

The taxpayer was granted the first non-transferable option covering 150 shares at $5 a share by a

---

and that such sales of stock are made in accordance with governmental laws or regulations.

4. Should employment with Michigan Chemical Corporation cease before June 30th, 1945, any allotments of stock which may be made to you on January 1st, 1945 will become null and void.

5. Should the employee on June 30th, 1945 so desire, arrangements will be made to extend the time for purchase of the stock to some future date to be determined by the Committee.

I am pleased to advise you that your name has been included in the names of key men to receive a tentative assignment of ten shares of Michigan Chemical stock, subject to the above conditions. The monthly figures during the year will show the results of your effort, both in your own department and in the plant as a whole. On or about January 1, 1945, a much larger portion of stock will be made available to the Committee for assignment to key employees on the basis of results accomplished. You may be assigned a greater or less amount of stock based entirely upon your individual results and that of the entire organization. Basic factors which should directly affect your accomplishments in departments will be labor costs both productive and non-productive, general expense items, maintenance of equipment, improvement in the efficiency of operations, increase in production, improvements in quality, simplified methods, new products, general operations in your department and cooperation with other direct and indirect departments.

May I suggest that you select those things wherein you can make the greatest contribution and strive to make the kind of record of which you and I may be proud.

May I also take this opportunity to congratulate you on being included in the initial list of those who have been selected as competent to perform outstanding service and thereby participate in the future of the Michigan Chemical Corporation.

Very truly yours,

(S.) T. C. Davis,
Executive Vice-President.

T.C. Davis:ag

letter from Mr. Davis, dated January 18, 1945.[3] (R. 144.) The fair market value of the stock in January, 1945, was $8.69 a share. (R. 145.) The option could be exercised on June 30 of that year if the recipient was then still employed by the corporation. The taxpayer was advised that the allotment of 150 shares to him was in recognition of his contribution and efforts in making the corporation successful. He was told that further allotments would be recommended in accordance with the plan and that it was up to him to justify his participation in the plan during the next two years.[4] (R. 18-20.)

---

[3] The corporation granted similar stock options to thirty-six other key employees in 1945. (R. 144.)

[4] Following is the full text of the letter of January 18, 1945 (R. 18-20):

January 18, 1945

Mr. Philip J. LoBue
126 Leonia
Leonia, New Jersey

Dear Phil:

You will recall that I wrote you under date of June 29, 1944, advising that your name had been included in a selected list of key employees to participate in a stock purchase plan provided by the stockholders at their meeting in March, 1944. In that letter, you were advised that you had tentatively been allotted ten shares of stock, which could be purchased by you at $5.00 per share, subject to the following conditions:

1. This tentative allotment will only become definite on January 1st, 1945, and only provided the Company's operations for the year have been profitable.

2. The stock will be issued by the Company direct to the employee upon payment therefor at the rate of $5.00 per share and as directed by the Committee.

3. The stock cannot be paid for nor received by the employee before June 30th, 1945. Participation in the

The taxpayer was granted the second non-transferable option to purchase an additional 150 shares at $5 a share under similar conditions by a

---

plan or receipt of stock is entirely contingent upon his being employed by Michigan Chemical at that time and that such sales of stock are made in accordance with governmental laws or regulations.

4. Should employment with Michigan Chemical Corporation cease before June 30th, 1945, any allotment of stock which may be made to you on January 1st, 1945, will become null and void.

5. Should the employee on June 30th, 1945, so desire, arrangements will be made to extend the time for purchase of the stock to some future date to be determined by the Committee.

I am pleased to advise you that the operations of the Company, though leaving much to be desired, were moderately profitable for the year 1944. The tentative allotment of stock made to you last June has now been changed and subject to the above conditions, you are definitely allotted 150 shares of the unissued common stock of the Michigan Chemical Corporation. This allotment of stock was made by the Committee and is in recognition of your contribution and efforts in making the operation of the Company successful.

The rights to subscribe to this stock are not transferable and will accrue to you directly providing all the conditions enumerated above are fully complied with.

As you know, we must continue to contribute our every effort toward the success of Michigan Chemical Corporation. There is much yet to be done to bring the Company along towards the attainment of our goal. This will require the most intensive work on the part of all of us during the current year. That we have a great opportunity is, I am sure, well known to you.

May I again congratulate you and suggest that you, as a stockholder, should be interested in seeing that the operations of the Company are as efficient as possible.

You will, of course, understand that further allotments of stock under our plan will be recommended by the Committee during 1945 and 1946 providing the conditions and

letter from Mr. Davis, dated January 1, 1946.[5] (R. 144.) The fair market value of the stock in January, 1946, was $19.25 a share. (R. 145.) The taxpayer was reminded that the extent of his participation in the plan was based on how well he handled his job during the year and that outstanding service was given added recognition in determining the number of shares assigned. He was told that it was only natural to expect a more rigid comparative appraisal of his efforts in the future; that any company was dependent upon its management and personnel for such success as might accrue to it; and that he was expected to contribute his share to the corporation's success.[6]

---

requirements are met. It is up to you to justify your participation in the plan during the next two years.

Very truly yours,

T. C. DAVIS,
Executive Vice-President.

T. C. Davis:ag.

[5] The corporation granted similar stock options to forty-seven other key employees in 1946. (R. 144.)

[6] Following is the full text of the letter of January 1, 1946 (R. 20-21):

New York, N. Y.,
January 1, 1946.

Mr. Philip J. LoBue
Leonia, New Jersey

Dear Phil:

It is with the greatest pleasure that I am writing to inform you that the Board of Directors of Michigan Chemical Corporation have approved the Committee's recommendation for the allotment of common stock of the Corporation to certain employees, for purchase at the price of $5.00 per share.

As you know, the stockholders at their meeting held in March, 1944, generously set aside 10,000 shares of the

Upon exercise of the two employee stock options in 1946,[7] the taxpayer received 300 shares of the

---

Corporation's common stock for purchase, over a period of three years, by selected employees at the price of $5.00 per share, which was the then approximate market price. You have from time to time been advised of the requirements incident to your participation in this purchase plan.

For the year 1945 the Committee has allotted you 150 shares of the common stock of Michigan Chemical Corporation, subject to your acquisition of these shares from the company at the rate of $5.00 per share on or before March 21, 1947. I am sure that you appreciate that generally, the value of common stock equities is closely tied to the success or failure of the corporation issuing such stock.

The Committee's selection of the names of employees to receive the right to purchase this stock and the number of shares assigned to each selectee is determined by the Committee after a careful appraisal of the individual's contribution to the company in the way of job performance during the past year. In other words, the extent of your participation in the plan is based on how well you handled your job during the year. Outstanding service to the company is given added recognition in determining the number of shares assigned. In this connection, I would like to point out to you that it is but natural to expect a more rigid comparative appraisal of your efforts in the future.

It is important we keep in mind that this plan permits you to participate in the future of your company on what now appears to be a very attractive basis. Any company is dependent upon its management and personnel for such success as may accrue to it. You are expected to contribute your share to our success. As a potential stockholder, you personally have a very definite reason to strive for the successful operation of your company beyond the mere holding of a job.

I am sure you recognize that there is much waste in most of our operations. Waste of materials, steam, water and of still greater importance the waste of time and

(Footnote 7 on page 13)

corporation's stock for $8,100 less than its fair market value at that time. (R. 144, 146.)

The taxpayer was granted the third non-transferable option to purchase an additional 40 shares under similar conditions by a letter from Mr. Davis, dated January 2, 1947.[8] (R. 145.) The taxpayer was again advised that allocations of shares, as in previous years, had been determined after a careful appraisal of the employee's contribution to the corporation's progress during the past year. Mr. Davis, pointing out that the value of the shares allotted to the taxpayer was considerably greater than in the preceding year, congratulated the tax-

---

labor. You should make every effort to correct these faults and where you know them to exist in part of the plant beyond your control, you should not hesitate to point them out to those responsible.

The Michigan Chemical Corporation is your company. You should feel in it the pride of ownership.

I congratulate you.

Yours very truly,

T. C. DAVIS,
Executive Vice-President.

T. C. Davis:ag.

(Reference for footnote 7 on page 12)

[7] On May 1, 1945, the taxpayer had given the corporation his promissory note for $750, payable on March 1, 1947, covering the 150 shares allotted to him under the first option. On January 3, 1946, the taxpayer had given the corporation his promissory note for $750, payable on March 1, 1947, covering the 150 shares allotted to him under the second option. (R. 27, 144.) On May 24, 1946, the taxpayer paid his two notes in the total amount of $1,500, and received the 300 shares of stock. (R. 144.)

[8] The corporation granted similar stock options to seventy-five other key employees in 1947. (R. 145.)

payer on having earned this recognition given to him and expressed the trust that the taxpayer's future services, suggestions and interest in the corporation's welfare would warrant even greater recognition.[9] (R. 21-22.)

---

[9] Following is the full text of the letter of January 2, 1947 (R. 21-22):

January 2, 1947

Mr. Philip J. Lobue
Palisades Park, New Jersey

Dear Phil:

It is with the greatest of pleasure that I am writing to inform you that the Board of Directors of Michigan Chemical Corporation has approved the Committee's recommendation for the allotment of the available common stock of the corporation at the price of $5 per share.

This allocation represents the balance of the 10,000 shares of the corporation's common stock which was made available by the Stockholders at their meeting held in March, 1944, for allocation to and purchase by selected employees over a three year period at a price of $5 per share, which was the approximate market value at that time. This letter will supplement the information furnished you from time to time pertaining to your participation in this plan.

For the year 1946, the Committee has allocated you 40 shares of the available common stock of the Michigan Chemical Corporation, subject to your acquisition of these shares from the Corporation at a price of $5 per share on or before March 21, 1947. It is urged that all stock be purchased prior to March 10, 1947, to allow sufficient time for stock certificates to be issued by the stock transfer agents prior to the above mentioned expiration date.

It is anticipated that some of the employees to whom stock allotments have been made will have questions regarding the procedure for purchasing the stock or that possibly they will not have available all the cash necessary to enable them to purchase the stock prior to the expiration date. The foregoing or any other matters per-

Upon exercise of this third stock option in February, 1947, the taxpayer received an additional 40 shares of the corporation's stock for $580 less than its fair market value at that time. (R. 145, 146.)

In its income tax returns for 1946 and 1947 the corporation deducted the amount of the difference between the option price at which it sold stock

---

taining to the stock allotments can be discussed with Mr. C. G. Woods.

The allocations for 1946, as in past years, have been determined by the Committee after a careful appraisal of the employee's contribution to the corporation's progress during the past year. The allocations are not as large as in past years. This is due to the fact that the number of shares available was less than in prior years and the number of employees to whom allocations were made was greater than previously. However, the value per share allocated is considerably greater this year than in previous years.

Again I wish to call your attention to the fact that these allocations afford you an opportunity to become a stockholder and thus participate in the future earnings of the corporation. The future progress and earnings of the corporation are largely dependent upon the loyal cooperation and efforts of each of its employees. The corporation's plans for 1947 include further expansion which should bring to you greater opportunities for participation in the future of your company both as an employee and stockholder. Incidentally, an employee should feel a certain amount of pride in also being a stockholder.

I congratulate you on having earned this recognition given to you by the Committee and trust that your future services, suggestions and interest in the corporation's welfare will warrant even greater recognition.

Very truly yours,

T. C. DAVIS,
President.

T. C. Davis: ag

to key employees during those years and the fair market value of that stock at such times. No deduction was taken by the corporation in its income tax return for 1945 with respect to stock allocated to employees under the stock option plan; nor did the corporation apply for or receive approval of the Salary Stabilization Unit for the granting of such options to its key employees. (R. 14.)

The taxpayer's returns having failed to reflect his receipt or exercise of the employee stock options, the Commissioner issued a deficiency notice in which he determined that, when the taxpayer in 1946 and 1947 received his employer-corporation's stock for less than its fair market value through exercise of the employee stock options, the taxpayer received taxable income in the nature of additional compensation in the amounts of $8,100 and $580 respectively. (R. 146.) A petition for redetermination having been filed, the Tax Court entered a decision in favor of the taxpayer, concluding that his exercise of the employee stock options did not result in his receipt of taxable income in the nature of compensation because the options had been granted to him for the purpose of providing him with a proprietary interest in the business, and holding invalid Section 29.22(a)-(1) of Treasury Regulations 111, as amended by T. D. 5507, 1946-1 Cum. Bull. 18, upon which the Commissioner relied. (R. 146-149.)

Agreeing that the Treasury regulation was invalid, the Court of Appeals for the Third Circuit affirmed the Tax Court's decision. In reaching

its conclusion, the Third Circuit reasoned (R. 162-163) that, notwithstanding the broad definition of gross income contained in Section 22(a) of the Internal Revenue Code of 1939, the taxpayer upon exercise of an employee stock option could receive an immediate economic benefit which, although not a gift, would not constitute taxable income but would be considered merely "incidental" if the intent of the employer-corporation in issuing the option was to have the taxpayer acquire a proprietary interest in its business.

SUMMARY OF ARGUMENT

In broadly defining gross income in Section 22 (a) of the Internal Revenue Code of 1939, Congress intended to tax all gains except those specifically exempted. The question in this case is whether the taxpayer realized a taxable gain in 1946 and 1947, when he was permitted to acquire his employer-corporation's stock for a fraction of its fair market value through the exercise of three stock options which that corporation had previously issued to him. Clearly, the taxpayer thereby received an economic benefit from his employer, and that benefit did not represent a gift. It represented income in the nature of compensation and, contrary to the conclusion of the courts below, its taxable nature was not affected by the employer's desire to have the taxpayer acquire a proprietary interest in its business. Accordingly, the Treasury Regulations which require such an employee's gain to be treated as compensation and included in

his gross income (unless shown to be a gift) constitute a valid interpretation of Section 22 (a).

The facts show that the economic benefit derived by the taxpayer represented compensation, i.e., was in consideration for his services, past, present, and future, as an employee of the corporation. On informing the taxpayer of its stock option plan, and when it issued each of the stock options to him, his employer emphasized that the options were being issued to him in recognition of his services as a key employee, and that the amount of optioned stock allocated to him was based on his accomplishments as such employee. That economic benefit was also treated as compensation paid in tax returns filed by the employer.

Nor did the employer's desire to have the taxpayer acquire a proprietary interest preclude his realization of taxable income in the nature of compensation. A corporation must necessarily intend any person to whom it sells its stock to acquire a proprietary interest in its business. Where the corporation sells an employee such stock for less than its fair market value, the employee receives an economic benefit in addition to a proprietary interest. There is no inconsistency involved in an employee's acquiring a proprietary interest and at the same time receiving taxable income in the nature of compensation. On the contrary, the two conclusions are consistent and complementary. Where, as here, no gift is involved, and a taxpayer must render services or serve as an employee to acquire a particular economic benefit, that benefit

represents taxable income in the nature of compensation, even though the employer conferring that economic benefit upon him may have had a "proprietary interest" motive. Unless the corporation intends to make a gift, the acquisition of a proprietary interest by its employees is but a means to an end, the ultimate end being the concrete reflection of that interest in valuable services by the employee. Thus, the employer's desire that his employee acquire a proprietary interest serves to confirm rather than negate the conclusion that the taxpayer's economic benefit represents compensation. Accordingly, the Regulations struck down by the courts below state an undeniable conclusion, namely, that (unless the facts show a gift) an economic benefit conferred because of the employment relationship is necessarily in return for services rendered or to be rendered, and hence represents taxable income in the nature of "compensation."

ARGUMENT

The Treasury Regulations, Under Which an Employee Realizes Taxable Income in Acquiring Stock in His Employer Corporation For Less Than Fair Market Value, Represent a Reasonable and Valid Interpretation of the Statute. The "Proprietary Interest" Test Applied by the Lower Courts Is Illogical and Erroneous

A. *In general: The nature of the issue.*

The issue in this case can be posed by a simple illustration. Suppose a corporation transfers an automobile worth $3,000 to an employee who pays the corporation $1,000 for it. Does the employee

pay an income tax on the $2,000 difference? The answer is, of course, that it depends on whether or not the transaction involved a gift to the extent of $2,000. If it appears from the facts that it was not a "gift of property", which is exempt from income tax under Section 22(b)(3) of the 1939 Code, *supra*, pp. 2-3, but rather that the transaction was an incident of the employer-employee relationship (that is to say, the employer transferred the property to the employee at less than fair market value, not because it was legally obligated to do so, but because in doing so it added to the employee's incentives for doing a good job, somewhat like a Christmas bonus), everyone agrees that the $2,000 economic gain received by the employee is in the nature of "compensation" taxable to him even though, strictly speaking, it is not part of his regular salary or wages.

The instant case involves the transfer to an employee not of an automobile but of the corporation's stock. Here an employee whose annual salary for the years 1946 and 1947 was $6,600 received from his employer, in addition, the right, which he exercised, to purchase 300 shares of stock worth $9,600 for $1,500, in 1946, and 40 shares of stock worth $780 for $200, in 1947. Such transactions, as was noted in the petition for certiorari, are becoming increasingly widespread. The popularity of this corporate practice is attributable, in part, to lower court decisions which, erroneously we submit, permit the favored employees to receive economic gain, in the form of the corporation's stock at a

bargain price, free of the same kind of tax burden borne by employees who receive their compensation in the form of cash or other types of property.

This Court held in 1945, in *Commissioner* v. *Smith*, 324 U.S. 177, that an employee can derive taxable income, in the nature of "compensation for personal service", when he exercises an option to purchase shares of stock at a price less than market value. Hence it is clear from the *Smith* case that, for tax purposes, there is nothing peculiar or unique about the transfer of corporate stock which differentiates it from transfers of other kinds of property. It is not the *nature* of the property transferred, therefore, which makes a difference in the stock-option situation. Where, then, lies the difference—and the explanation for the increasing popularity of the practice, for tax-reduction purposes, of rewarding valued employees by giving them options to buy stock in the employer corporation at lower prices than they would have to pay on the open market?

The explanation lies in the so-called "proprietary interest" test which has been developed, without any explicable basis in the statute or regulations, by the Tax Court and some Courts of Appeals. Perhaps the most persuasive statement of the "proprietary interest" test, and the reasons underlying it, are contained in Judge Maris' opinion for the court below (R. 162-163). It states:

> It is denying the facts of economic life to assert that every grant of a stock option to a corporation's employee is necessarily addi-

tional compensation to the extent that at the time of exercise the market value of the stock exceeds the option price. For it is a well known and common practice of American business corporations to seek to retain the continued interest in the business of their key employees by inducing them through favorable stock options to acquire a proprietary interest as stockholders. In a great many such cases the immediate economic benefit to the employee is minor, incidental and, often, quite fortuitous. Such transactions are, however, not gifts for there is a very real consideration to the corporation, the continued interest of a key employee. There are, of course, other cases in which the element of compensation is the important one. But the fact that there is an element of immediate economic benefit does not exclude the conclusion that the option was given solely to provide the employee with a proprietary interest and that the immediate benefit was purely incidental and not compensatory.

In short the Court of Appeals thought the controlling question is one of fact: if compensation to the employee was intended, the gain he receives is taxable income; if, however, the employer intended that the employee acquire a proprietary interest in the business, no taxable gain results. In other words, "compensation" and "acquisition of a proprietary interest" are to be treated as

mutually exclusive categories. In every case taxability would hinge upon a question of fact: what was the employer's intention? And the answer must be either "compensation" or "proprietary interest", one or the other, and never both.

The Government submits, however, that this test of taxability is patently illogical and erroneous under the statute. There is no inconsistency, as a matter of fact, between an intention to increase a key employee's compensation by allowing him to acquire the corporation's stock at a price substantially less than its value, and a desire that he acquire a proprietary interest in the business. The two motives, far from being necessarily contradictory, as the court below thought, are usually complementary. An employer may, and in most cases probably does, have both objects in mind in granting an option.

If there is an intention to "compensate", in the sense that the options are given as an incident of the employer-employee relationship and not as a gift, the gain realized by the employee is taxable to him as income, even though the employer may also have had a "proprietary interest" motive. The presence of the latter fact should be immaterial, so far as taxability is concerned.

It is possible, of course, that an option may be given purely as a gift, for donative reasons wholly uninfluenced by the fact that the donor happens to be the donee's employer. Where that is the case, obviously no taxable income is realized by

the employee upon acquisition of the stock, because it is a "gift of property" excluded from tax under Section 22(b)(3). But there is no contention here that this case involves a "gift of property". In the passage from its opinion quoted, *supra*, pp. 21-22, the Court of Appeals expressly recognized that these transaction are "not gifts for there is a very real consideration to the corporation, the continued interest of a key employee." It recognized, also, that the employee, when he acquired the stock, derived an "immediate economic benefit." Yet it held that the receipt of such benefit was not taxable income because it is "minor, incidental and, often, quite fortuitous." But we know of no authority, either in the statute or judicial precedents, for holding that gains otherwise taxable are not to be taxed because they are "incidental", or "fortuitous". Unless the gains are found to have been received as gifts, they constitute income. We agree with the lower courts that in cases of this kind there is a controlling question of fact. But the inquiry is not, was this "compensation" or was it "acquisition of a proprietary interest"? Rather, the question is, simply, was this a "gift" which the employer made? Or was it given in recognition of, and in consideration (though not in any technical legal sense) for, the employee's interest and services, past, present, and future? If so, it is, as correctly stated in the Regulations, in the nature of "compensation" and hence taxable as income.

B. *The statute and the Regulations*

Section 22 (a) of the Internal Revenue Code of 1939, *supra*, p. 2, defines the term "gross income" to include:

> * * * gains, profits, and income derived from salaries, wages, or compensation for personal service * * *, of whatever kind and in whatever form paid * * * or gains or profits and income derived from any source whatever.

In so defining gross income, as it has ever since 1913,[10] Congress exerted "the full measure of its taxing power" and intended "to tax all gains except those specifically exempted." *Commissioner* v. *Glenshaw Glass Co.*, 348 U.S. 426, 429-430. See *Rutkin* v. *United States*, 343 U.S. 130; *Commissioner* v. *Jacobson*, 336 U.S. 28, 49; *Helvering* v. *Bruun*, 309 U.S. 461, 468; *Helvering* v. *Clifford*, 309 U.S. 331, 334; *Douglas* v. *Willcuts*, 296 U.S. 1, 9; *Irwin* v. *Gavit*, 268 U.S. 161, 166; *Robertson* v. *United States*, 343 U.S. 711. And, while Congress, in Section 22 (b), has acted to exempt certain described gains from tax, such as gifts of property in Section 22 (b)(3), these exemptions are strictly construed; and it is incumbent upon the taxpayer claiming the benefit of any exemption to establish that his gain comes within the excluded category specified by Congress. *Helvering* v. *Northwest Steel Mills*, 311 U.S. 46, 49; *Commissioner* v. *Jacobson*, *supra*, p. 49.

---

[10] Section II B, Income Tax Act of 1913, c. 16, 38 Stat. 114.

Where an employee, as a consequence of his employment, is permitted to buy property from his employer at less than true value, taxable income is received. Such a transaction is not the same as a simple purchase of property in which there will be no tax consequences until a later sale or other disposition of the property. See *Palmer* v. *Commissioner*, 302 U.S. 63, 68-69. In the former situation, the person acquiring the property not only pays cash but also renders services as an employee so that the difference between the actual value of the property and the price paid for it is attributable to his employment. See *Geeseman* v. *Commissioner*, 38 B.T.A. 258, 263. The employee is buying the property, partly for cash and partly in exchange for his services, the cash price paid and the value of the services rendered or to be rendered being the consideration for the property received. The situation is the same as though the employee, in addition to his normal salary, has received an extra cash payment which he, in turn, uses in paying the fair market price of the property. The acquisition of property on the sale of services, consequently, results in a closed taxable transaction even though a simple purchase of property does not. See *Commissioner* v. *Smith*, 324 U.S. 177, rehearing denied, 324 U.S. 695, where this Court held that an employee could receive compensation in the form of a bargain purchase.

Treasury Regulations interpreting the provisions of Code Section 22 (a) and its statutory predecessors have long provided that the employee

realizes taxable income when, by reason of his employment, he receives property from his employer for a price which is substantially less than fair market value. The regulation which the courts below held invalid, Section 29.22(a)-1 of Treasury Regulations 111, as amended by T.D. 5507, *supra*, pp. 4-5,[11] provides:

> If property is transferred by an employer to an employee for an amount less than its fair market value, regardless of whether the transfer is in the form of a sale or exchange, the difference between the amount paid for the property and the amount of its fair market value is in the nature of compensation and

---

[11] This regulation, as so amended, is not applicable to the option issued on January 18, 1945. The regulation in effect with respect to that option provides (Section 29.22(a)-1 of Treasury Regulations 111, *supra*, pp. 3-4):

> If property is transferred by a corporation to a shareholder, or by an employer to an employee, for an amount substantially less than its fair market value, regardless of whether the transfer is in the guise of a sale or exchange, such shareholder or employee shall include in gross income the difference between the amount paid for the property and the amount of its fair market value to the extent that such difference is in the nature of (1) compensation for services rendered or to be rendered or (2) a distribution of earnings or profits taxable as a dividend, as the case may be. In computing the gain or loss from the subsequent sale of such property its basis shall be the amount paid for the property, increased by the amount of such difference included in gross income. * * *

As we shall establish, the courts below also erred in concluding that, under that regulation, no compensatory income was realized through the medium of that option.

> shall be included in the gross income of the employee. * * *

It will be observed that this regulation comes into operation only upon the concurrence of certain conditions stated or implicit. First, there must be a transfer of property from employer to employee. Second, the regulation necessarily implies that the transfer of property must be peculiar to or occasioned by the employment relationship. Consequently, the regulation does not apply where a true gift is involved. See *Bogardus* v. *Commissioner*, 302 U.S. 34. Finally, the fair market value of the property must be greater than the amount paid for it by the taxpayer-employee. It is our position that this regulation—which must, of course, be read together with the regulation interpreting the statutory provision exempting gifts from income tax—represents a proper construction of Section 22 (a) of the Internal Revenue Code of 1939; and that, accordingly, the courts below were wrong in invalidating the regulation for failing to provide for some middle ground between a tax exempt gift and taxable compensation in the type of situation exemplified by this case.

C. *Under the statute and Regulations the taxpayer clearly received income in the nature of compensation.*

A review of the undisputed facts in this case compels the conclusion that the taxpayer received taxable income in the nature of compensation

through the medium of the three employee stock options.[12] Since in the instant case, the option price was substantially less than the fair market value of the optioned stock, both at the time the taxpayer received the options and at the time he exercised them,[13] it cannot be seriously contended that he did not receive an economic benefit through the medium of those options. Indeed, neither the Tax Court nor the Court of Appeals attempted to deny the uncontrovertible fact that the taxpayer received an immediate economic benefit when he was enabled to buy the stock at a price considerably less than its true value. In view of this Court's decision in *Commissioner* v. *Smith*, 324 U.S. 177,

---

[12] We do not, of course, take issue with the underlying facts found by the Tax Court, which merely reflect the uncontroverted evidence. We do, however, contest the correctness of its ultimate conclusion which was stated in its findings of fact (R. 146) that the economic benefits conferred on the taxpayer were not "compensation for services"—a conclusion which, as its opinion makes clear (R. 146-149), the Tax Court thought inevitably followed from its finding that the options were granted to give him a proprietary interest. The same erroneous legal theory was adopted by the Court of Appeals.

[13] The number of shares of stock covered by each of the three options, the option price of each share, the fair market value of each share when the options were issued, and the fair market value of each share when acquired by the taxpayer, were as follows (R. 143, 144, 145):

Option issued	Number of shares covered by option	Option price per share	Fair market value when option was issued	Fair market value when stock was acquired
January, 1945	150	$5.00	$ 8.69	$30.50
January, 1946	150	5.00	19.25	30.50
January, 1947	40	5.00	?	19.50

rehearing denied, 324 U.S. 695, it cannot be disputed that in receiving such economic benefit the taxpayer received taxable income if that economic benefit represented compensation and was not an exempt "gift of property". The criterion for determining whether that economic benefit represented compensation within the meaning of Code Section 22 (a) is whether it was "in return for services" rendered or to be rendered. *Robertson* v. *United States*, 343 U.S. 711, 714. See also *Old Colony Tr. Co.* v. *Commissioner*, 279 U.S. 716, 729.

Initially, on informing the taxpayer of the proposed stock option plan, his employer-corporation repeatedly stated that the allotment of shares to key men would be based "on results accomplished". The taxpayer was told that participation in the plan and the receipt of stock thereunder was "entirely contingent upon his being employed" by the company. The taxpayer was advised—"you will stand on your own record and participate in the stock purchase plan to the extent of your efforts, cooperation and results". Basic factors which should directly affect the taxpayer's accomplishments were enumerated, and it was suggested that he select those things in which he could make the greatest contribution. Finally, he was congratulated upon being included among those selected as "competent to perform outstanding service and thereby participate in the future of the Michigan Chemical Corporation". (R. 17-18.)

On issuing the first stock option allotting 150

shares to the taxpayer, his employer-corporation informed him (R. 19):

> This allotment of stock was made by the Committee and is in recognition of your contribution and efforts in making the operation of the Company successful.

At the same time, with respect to future allotments, the taxpayer was told (R. 20):

> It is up to you to justify your participation in the plan during the next two years.

On issuing the second stock option, allotting an additional 150 shares to the taxpayer, his employer-corporation pointed out that generally the value of common stock equities is closely tied to the success or failure of the corporation issuing such stock. (R. 20.) The taxpayer was told (R. 20-21):

> The Committee's selection of the names of employees to receive the right to purchase this stock and the number of shares assigned to each selectee is determined by the Committee after a careful appraisal of the individual's contribution to the company in the way of job performance during the past year. In other words, the extent of your participation in the plan is based on how well you handled your job during the year. Outstanding service to the company is given added recognition in determining the number of shares assigned. In this connection, I would like to point out to

you that it is but natural to expect a more rigid comparative appraisal of your efforts in the future.

It is important we keep in mind that this plan permits you to participate in the future of your company on what now appears to be a very attractive basis. Any company is dependent upon its management and personnel for such success as may accrue to it. You are expected to contribute your share to our success. As a potential stockholder, you personally have a very definite reason to strive for the successful operation of your company beyond the mere holding of a job.

On issuing the third stock option, allotting an additional 40 shares to the taxpayer, his employer-corporation advised him (R. 22):

> The allocations for 1946, as in past years, have been determined by the Committee after a careful appraisal of the employee's contribution to the corporation's progress during the past year.

Finally, after pointing out that "the value per share allocated is considerably greater this year than in previous years", the employer-corporation congratulated the taxpayer "on having earned this recognition given to you by the Committee" and told him of its trust that even greater recognition would be warranted for "your future services,

suggestions and interest in the corporation's welfare". (R. 22.)

If more were needed to show that the stock options were issued to the taxpayer in return for his services, it would be found in the fact that the corporate-employer claimed corresponding deductions in its tax returns. Thus, on permitting the taxpayer to purchase its stock for substantially less than the stock's fair market value in 1946 and 1947, the employer-corporation deducted the difference in its income tax returns for those years.[14] (R. 145.) Noteworthy, too in this connection, is the fact that by taking these deductions, the employer-corporation not only ratified its accountant's treatment of the options as representing compensation for services, but also did so after its president, Mr. Davis (who was also the recipient of 5,000 shares of optioned stock not here involved) had attempted to convince those accountants that the options were not compensatory. (R. 134-135.)

---

[14] For the year 1945, the corporation did not claim a tax deduction with respect to stock options granted to employees in that year; the corporation had not made an application for and had not received approval from the Salary Stabilization Unit for granting such stock options. (R. 14.) For salary stabilization purposes such options constituted salary payments. Mim. S.S.U. 65, August 15, 1944 (1945 C.C.H., par. 53.105). Any unauthorized increases in salary would have been both unlawful and nondeductible. Stabilization Act of 1942, c. 578, 56 Stat. 765 (50 U.S.C. Appendix, 1946 ed., Secs. 961-971); 32 Code of Federal Regulations (1943 Supp.), c. XVIII, Sec. 4001.10; Sec. 29.23(a)-16 of Treasury Regulations 111.

D. The "proprietary interest" test, applied by the courts below, is erroneous under the statute.

The theory of the courts below is that in employee stock option transactions employees do not receive taxable income (which is compensatory or comes within any taxable category) if the employer-corporation in issuing the options is motivated by a desire to grant them a proprietary interest in its affairs. Both courts seem to regard such a motive as being the very antithesis of an intention to pay compensation. Thus, the opinion of the Tax Court, from which four judges dissented, while recognizing that (R. 149) an element of compensation and the desire to grant a proprietary interest may exist together, decided the case on the assumption (R. 146) that either one or the other had to be controlling. That is, it concluded that (R. 146) "If the options were intended as additional compensation," taxable income would have been received by the taxpayer, but "If the options were granted to provide him with a proprietary interest in the business," no taxable gain could be "recognized when the options are exercised." [15] Finding, in accordance with evidence

---

[15] Other cases have also been decided on such a basis. We cite, as typical: *Adams* v. *Commissioner*, 39 B.T.A. 387; *Rosenberg* v. *Commissioner*, 20 T.C. 5; *Bowen* v. *Commissioner*, decided July 22, 1954 (1954 P-H T.C. Memorandum Decisions, par. 54,207); *Commissioner* v. *Straus*, 208 F. 2d 325 (C.A. 7th); *Bradner* v. *Commissioner*, decided June 4, 1952 (1952 P-H T.C. Memorandum Decisions, par. 52,175), affirmed *per curiam*, 209 F. 2d 956 (C.A. 6th).

adduced by the taxpayer, that the employer granted the options because of a desire to give the employees an opportunity of acquiring a stock interest, the Tax Court concluded that the options were granted to the taxpayer (R. 146) "to give him a proprietary interest in the Corporation, and not as compensation for services." On that basis, it held that no taxable income was received when the taxpayer was enabled to acquire the stock at less than its true value.[16]

The Court of Appeals followed a similar line of reasoning. It stated and accepted as a correct principle of law the assumptions that (R. 160) stock options are *either* intended as additional compensation *or* are intended to grant a proprietary interest, and that in the latter situation no taxable income is realized by the employee on the exercise of the option. It stated that (R. 160) "whether the grant of the option *is the one or the other*" is "in every case a question of fact." (Emphasis added.)

The theory of the courts below, as has been shown *supra*, pp. 23-24, will not withstand analysis. In the first place, there is no inconsistency involved in an employee's acquiring a proprietary interest and at the same time receiving taxable income in the na-

---

[16] The Tax Court did also note (R. 149) that the option price slightly exceeded the fair market value of the stock when the plan was first adopted and the option price was established. This fact, however, loses significance when it is borne in mind not only that the employees were not bound to exercise the options, but also that the option price was substantially below the fair market value of the stock both when the options were actually issued and when they were exercised. See fn. 13, *supra*, p. 29.

ture of compensation on the exercise of the stock option. A corporation must necessarily intend any person to whom it sells its stock, by option or otherwise, to acquire a proprietary interest. Consequently, it is a truism that whenever an employer-corporation grants options to its employees to purchase its own stock, it necessarily intends to give them an opportunity to acquire a proprietary interest in its business. The employee would, of course, acquire a proprietary interest if he paid the full fair market value for the stock. And, where the acquisition of the stock is at a price less than that at which such stock is being sold to others, the employee obviously receives an economic benefit in addition to a proprietary interest.

Secondly, we are dealing here with the express language of a statute. As already observed, Congress has defined taxable income in Section 22 (a) in the most sweeping terms. While the statute expressly exempts certain types of income, including "gifts of property" (Section 22 (b) (3)), there is no claim that the admitted economic gain which the present taxpayer realized comes within these exceptions. Congress has supplied no express or implied basis to support the view that taxation of an admitted economic gain received by an employee should be defeated because the employer is motivated by a desire to grant the employee an opportunity of acquiring a proprietary interest in its business.

That Congress has acted on an assumption opposite to that employed by the courts below, namely,

that the employer's motive of granting a proprietary interest is without significance, is evident from its enactment of the restricted stock option provisions contained in Section 130A of the Internal Revenue Code of 1939, as added by Section 218 of the Revenue Act of 1950, c. 994, 64 Stat. 906, now reenacted as Section 421 of the Internal Revenue Code of 1954. When Congress enacted those restricted stock option provisions, it gave preferential tax treatment to employee stock options meeting certain prescribed qualifications and safeguards.[17] See S. Rep. No. 2375, 81st Cong., 2d Sess., pp. 59-60 (1950-2 Cum. Bull. 483, 526). Under those provisions, the tax on the gain realized by an employee when he acquires his employer-corpora-

---

[17] Among the conditions which must be met by a "restricted" stock option in order to qualify for preferential treatment under the 1950 amendment are the following:

The option price at the time of issuance must be 85% or more of the fair market value of the stock. The option must not be transferable *inter vivos*. The individual must exercise the option during his employment or within three months after he ceases to be an employee. The individual must not dispose of the stock within six months after its acquisition or within two years after acquisition of the option. The recipient of the option must not own, directly or indirectly, stock possessing more than 10% of the total combined voting power of all classes of stock.

tion's stock for less than its fair market value through the exercise of a restricted employee stock option is postponed until the employee sells the stock. At such time, his gain (which is measured by the difference between the option price and the fair market value of the stock when the option is granted or when the stock is disposed of, whichever is less) is taxed as ordinary income unless the option price was 95% or more of the fair market value of the stock when the option was issued. It will be noted that, even in the precise area where Congress has provided this carefully limited special treatment for employee stock options, the employer's intent to grant a "proprietary interest" is not a relevant factor in determining tax consequences.

The "proprietary interest" theory, used by the courts below to justify their conclusion that no income is realized, if it were valid, would defeat the Congressional purpose of granting some special tax benefits only where the prescribed conditions have been met. That is, if the courts below are correct in their conclusion that the economic gain conferred on the employee is not embraced by the all-inclusive definition of income contained in Section 22 (a) where the motive is one of granting a proprietary interest, there will be no need for complying with the statutory safeguards in any other situation where a similar motive exists. And the vice of the decisions below goes further—unlike the statutory provisions dealing with restricted stock options which insure that the employee will eventually be

taxed with *ordinary income* (except where the initial spread is 5% or less), the decisions of the courts below not only postpone the tax until the stock is sold, but also have the effect of taxing the entire gain at that point as *capital gain* at preferential rates and of freeing his gain from any income tax whatsoever if the taxpayer dies without having sold the stock.

We submit, accordingly, that Congress could not have shared the view of the courts below.

Further, under Section 22(a) (in the absence of an intention to make a gift) it is quite unimportant that the employer may not fully appreciate that the intended effect of conferring an economic benefit on its employees results in the payment of compensation. So long as the economic benefit is "connected with, or conditioned on, rendering services and thus connected with his employment," it seems plain that the employee was intended to receive compensation which is taxable income under Section 22 (a). *Van Dusen* v. *Commissioner*, 8 T.C. 388, 393, affirmed, 166 F. 2d 647 (C.A. 9th). As the court stated in *Bass* v. *Hawley*, 62 F. 2d 721, 723 (C.A. 5th), it was the purpose of Congress in Section 22 (a) that—

> all receipts in whatever form that come because of labor and service, whether payment could be compelled or not, shall be taxed as arising from labor.

Consequently, where a taxpayer must perform services or serve as an employee (as is true here) to

receive a certain economic benefit, and where no gift or other type of excludable income is involved, the employer-corporation necessarily intends the consequences of its actions, i.e., to confer compensation on the employee for services rendered or to be rendered.

Nor can it be important, in applying the broad sweep of Section 22 (a), that the employer who confers an economic benefit on his employee as a reward for services rendered or as an inducement for the rendering of future services, is also actuated by motives (whether or not those are the principal or dominating ones) which are not necessarily associated with an intent to compensate. Thus, in *Robertson* v. *United States*, 343 U.S. 711, Reichhold, in granting an award for the best symphonic work, was motivated principally by the desire to benefit the public at large by bringing to it the best new music written in the Americas and to benefit the Detroit Symphony Orchestra by giving it certain rights in the winning composition. Notwithstanding these philanthropic motives and the lack of any economic advantage to Reichhold, it was held that the taxpayer in *Robertson* received taxable income when he submitted a composition, which he had previously written, and received an award of $25,000. This Court said (p. 714):

> Where the payment is in return for services rendered, it is irrelevant that the donor derives no economic benefit from it.

Although, as is demonstrated by *Robertson*, it is irrelevant that the employer may be actuated by

other motives—taxable income being received so long as the economic benefit given the employee is related to services rendered or to be rendered—it should be observed that the motive of granting a proprietary interest in this case cannot actually be divorced from an ultimate intent to compensate. Thus, T. C. Davis, an officer and director of the company, who was the only witness, testified that his original purpose in suggesting the option plan was to (R. 133)—

> provide some means to have our key employees have a proprietary interest in the company, because it has always been my feeling that is better for a company and better for the employees.

But there is only one way in which a plan giving employees a proprietary interest in the business could possibly be "better" for the employer-corporation; it must result in the rendering of further services by employees who are thereby induced to remain in employment or are induced to work harder or more efficiently.

From a general viewpoint, as well as in the context of the particular facts of this case, it seems impossible that an employer, in providing its employees with the opportunity of purchasing its stock on favorable terms, can confer an economic advantage which is something other than compensation simply because it is actuated by a desire that the employees acquire a proprietary interest. No matter what the terms used to describe the advantages which flow to the corporation from hav-

ing its key employees occupy the position of stockholders, i.e., increased loyalty, interest, devotion, pride, etc., they refer to the same ultimate purpose, namely, the rendition of services by such employees. The proprietary interest theory, namely, that some corporations confer on certain of their servants the right to become a proprietor of the corporation (for less than other buyers are prepared to pay for that same right) not in return for services rendered or to be rendered, but merely from a desire to see the employee a proprietor of the corporation, is analytically incomplete. It describes two things, but not an essential third. It describes the corporate motive in so far as a corporation can have a motive. It describes what it is that the corporation is motivated to give the employee. But it fails to answer the question whether the corporation is to get anything and, if so, what. If the corporation gets nothing, the transaction is a waste of corporate assets.[18] If it gets some-

---

[18] As a general rule of corporate law, any distribution of valuable property rights by a corporation is an actionable waste of corporate assets unless the corporation receives in return not only services, but services commensurate in value with the value of property distributed. *Rogers* v. *Hill*, 289 U.S. 582; *Commissioner* v. *Bonwit*, 87 F. 2d 764, 765 (C.A. 2d), certiorari denied, 302 U.S. 694. Recent decisions with respect to employee stock option plans have made it clear that the principles enunciated in *Rogers* v. *Hill*, *supra*, apply to distribution by way of options to buy the distributing corporation's stock. *Elster* v. *American Airlines*, 100 A. 2d 219 (Del. Ch.); *Eliasberg* v. *Standard Oil Co.*, 92 A. 2d 862 (N.J. Super.); affirmed *per curiam*, 97 A. 2d 437 (N.J.); *Kaufman* v. *Shoenberg*, 91 A. 2d 786 (Del. Ch.); *Gottlieb* v. *Heyden Chemical Corp.*, 92 A. 2d 594 (Del.); *Kerbs* v. *California Eastern Air-*

thing, it is not enough to say that it gets "interest", "loyalty", etc. A business corporation does not thrive on emotional attitudes or sentiments directed toward it, unless they result in some concrete advantage in the conduct of its business. A vendor to, or a purchaser from, or a servant of the corporation who has a stake in the corporation's fate may well give the corporation a trading advantage or a service advantage. But a person who neither sells to, buys from, nor serves the corporation is not the least bit of use to it no matter how much he desires the corporation to succeed. A business corporation exists to make money, and, from the point of view of the corporation as an entity pursuing its one purpose, it is a matter of complete indifference whether its stock is issued to disinterested A or interested B unless B's interest is reflected in some way to its advantage.

We submit that the Court of Appeals, in speaking of the "facts of economic life" and in taking note of the corporate practice of giving favorable stock options in order to (R. 162) "seek to retain the continued interest in the business of their key employees" and in conceding that the economic benefits conferred on such employees are not gifts because (R. 163) "there is a very real consideration to the corporation" in the "continued interest

---

ways, 90 A. 2d 652 (Del.), reargument denied, 91 A. 2d 62; *Truncale* v. *Universal Pictures Co.*, 76 F. Supp. 465 (S.D. N.Y.); *Holthusen* v. *Edward G. Budd Mfg. Co.*, 53 F. Supp. 488 (E.D. Pa.).

of a key employee", was describing the basic elements of compensation.[19] Yet, strangely enough, the Court of Appeals was so convinced that this was the antithesis of compensation that it struck down the Regulations for failing to incorporate such a principle.

In short, the motive here of granting the employees an opportunity of acquiring a proprietary interest is an inseparable aspect of an ultimate intent to grant compensation. The nexus between the two is undeniable even though the employer may have been honestly unaware of it and may not have thought through the intended effect of its granting such an economic benefit. Accordingly, far from detracting from or standing in opposition to the intent to compensate (an intent conclusively established by the evidence discussed at pp. 28-33, *supra*) the employer's desire here to grant a proprietary interest in its business is in full harmony with the ultimate conclusion for which we contend, namely, that the taxpayer did receive an economic benefit which is taxable under Section 22(a). In this respect, the present case is a stronger one than *Robertson* where an extraneous motive, having no relationship to an intent to compensate, was present.

In view of the foregoing, we believe that the

---

[19] As Dean Griswold has said (Surrey & Warren, *Federal Income Taxation* 603 (Second ed., 1953)):

> I really do not see how it is possible to give a stock option to an executive which is not available to anyone else, without its being compensation.

Treasury Regulations (far from being invalid, as held by the court below for failing to adopt a "proprietary interest" theory) represent a correct interpretation of Section 22(a) in the kind of circumstances of which this case is typical.[20] Since, as we have shown, the "proprietary interest" concept is not opposed to (but indeed is an aspect of) the granting of compensatory income, the Court of Appeals erred in striking down the Regulations as though they were an incorrect interpretation of the basic statute. Where no gift is involved, the Regulations state an undeniable conclusion, namely, that an economic benefit conferred because of the employment relationship is necessarily in return for services rendered or to be rendered, and hence represents compensatory income.

As we have previously indicated (See fn. 11, *supra*), the Regulations applicable to the option issued on January 18, 1945, provided that on an employee's purchase of property from his employer at a price less than fair market value the difference represents taxable income "to the extent that such difference is in the nature of compensation." In view of the foregoing discussion, we believe that the

---

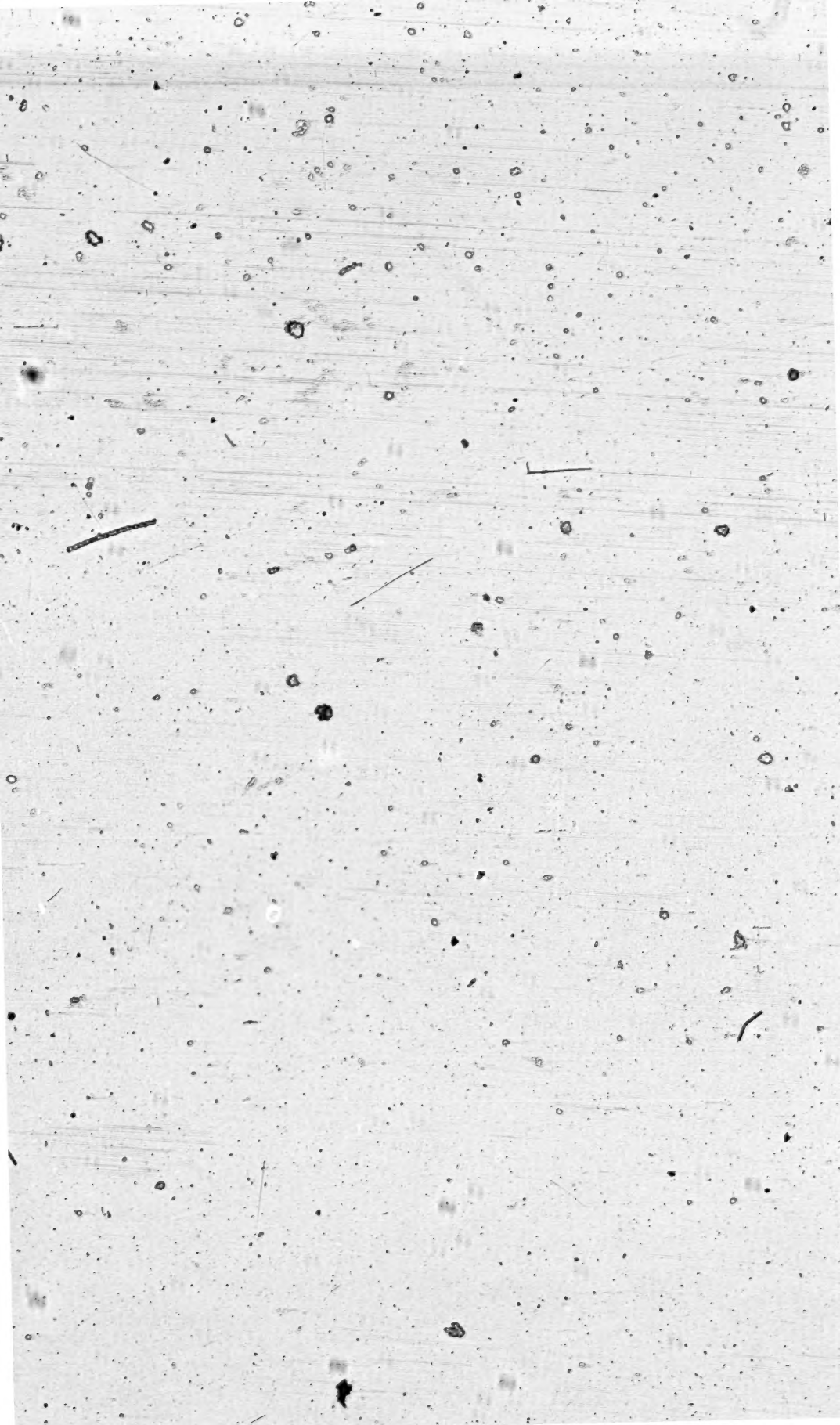
[20] Under the uniform rulings of this Court, such Treasury Regulations must be sustained unless unreasonable and plainly inconsistent with the statute which they interpret; they are not to be overruled except for weighty reasons. *Lykes* v. *United States*, 343 U.S. 118; *Commissioner* v. *South Texas Co.*, 333 U.S. 496; *Commissioner* v. *Wheeler*, 324 U.S. 542; *Helvering* v. *Wilshire Oil Co.*, 308 U.S. 90; *Fawcus Machine Co.* v. *United States*, 282 U.S. 375; *Brewster* v. *Gage*, 280 U.S. 327; *Boske* v. *Comingore*, 177 U.S. 459.

uncontradicted evidence in this case permits but one conclusion, namely, that in the case of that option also the taxpayer received a gain which was in the nature of compensation.

E. *The amount of compensation involved.*

If this Court agrees with the Commissioner that the taxpayer received compensatory income, there remains for consideration an alternative allegation, raised by the taxpayer's petition in the Tax Court and urged by him in the Court of Appeals. That is, the taxpayer argued that if the Commissioner was correct in determining that taxable gain was received, he erred in measuring the gain as of the time the stock was paid for in cash and the stock certificates delivered, it being contended, in effect, that the options were actually exercised (and the gain was to be measured at that time) when the taxpayer gave promissory notes equal to the option price of the stock.

We believe, in view of what was decided in *Commissioner* v. *Smith*, 324 U.S. 177, on the denial of rehearing, 324 U.S. 695, that the Commissioner made a correct determination concerning the time when the options were exercised. However, in view of the fact that the lower courts did not reach this additional issue, it would seem appropriate for the case to be remanded to the Tax Court in order that it may have an opportunity of passing on this question.



CONCLUSION

For the foregoing reasons the judgment of the court below should be reversed.

Respectfully submitted,

SIMON E. SOBELOFF,
Solicitor General,
H. BRIAN HOLLAND,
Assistant Attorney General,
PHILIP ELMAN,
Assistant to the Solicitor General,
HILBERT P. ZARKY,
JOSEPH F. GOETTEN,
Attorneys.

January, 1956.

☆ U. S. GOVERNMENT PRINTING OFFICE: 1956 . 871491 . 810